No. 84-264

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IN THE

Supreme Court of the United States

October Term, 1984

CHEMICAL BANK,

Petitioner,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

MANUFACTURERS HANOVER TRUST COMPANY AND FIRST PENNSYLVANIA BANK, N.A.,

Petitioners,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

SECURITY PACIFIC NATIONAL BANK,

Petitioner,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF OF PETITIONERS

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REPLY BRIEF OF PETITIONERS

Petitioner banks (the "Banks") hereby reply to the Brief In Opposition of respondent Andersen and request that this Court grant the Banks' petition for a writ of certiorari (the "Petition").[1]

Andersen has attempted to belittle the Petition by posing artificially narrow questions for review and then misconstruing the law and asking the Court to rule on the facts in response to such skewed questions. But this Court should not be diverted from addressing the very significant legal questions presented for review by the Petition which have such great importance to the civil and criminal enforcement of the antifraud provisions of the federal securities laws.[2] Nor should this Court be deterred from granting review by Andersen's effort to obfuscate the serious, irreconcilable conflicts that the Second Circuit majority opinion creates with precedent of this Court and among the Circuits.

I. The Second Circuit Majority's Holding That Fraud Was Not "In Connection With" The Pledge And Guarantee Transaction Is Contrary To All Precedent

Andersen cannot directly dispute that a pledge of stock is a sale of securities. *Rubin* v. *United States*, 449 U.S. 424, 431 (1981). However, it tries to do so indirectly. Here, as one part of an integrated capital financing and restructuring of Frigitemp Corp., the Banks loaned $4 million to Frigitemp's wholly-owned subsidiary (Elsters); Frigitemp guaranteed repayment of that loan and to secure its guarantee, pledged 100% of the stock of Elsters. The record,

1. References to the Petition are cited "(Pet.)." References to the appendix to the Petition are cited "(a)." References to Andersen's Brief In Opposition are cited "(Opp.)."

2. § 17(a) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C.A. § 77q(a) (1981); § 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C.A. § 78j(b) (1981); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983).

upon which, with respect to the merits of the Banks' fraud allegations, the District Court refused to grant Andersen summary judgment or dismissal (50a n.9, 72a-80a), is clear. It is uncontroverted that this was "one integrated transaction" (72a n.30), no part of which, including the loan or the guarantee, could have taken place without the pledge of stock (47a). On a motion for summary judgment or dismissal, these facts must be accepted as true and construed favorably to the Banks.[3] The critical guarantee and pledge were made by the very company, Frigitemp, which Andersen fraudulently pictured in its certified financial statements as financially healthy.

In the Petition, the Banks demonstrated that the test of *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971) (at 95a), for determining when fraud is "in connection with" a securities transaction was easily met in this case. In *Superintendent*, this Court specifically ruled that the fraud need not directly relate to the value of the securities in question and indeed need only be "touching" the securities part of the transaction.[4] The Second Circuit below held to the contrary: the fraud here was not sufficiently "in connection with" because the fraud did not directly relate to the value of the Elsters stock.

However, the fraud did touch on the transaction in which the Elsters stock was pledged. The fraud, guarantee and

3. Andersen's attempt here to create a new record absolving itself of fraud flies in the face of the unappealed rulings by the District Court on the merits and the statement, even by the majority below, recognizing that the Banks had adequately alleged a fraud by Andersen (33a n.22). For a recent independent account of Andersen's central role in the fraud, see Fialka, *Tale of Deceit: Why Arthur Andersen Was So Slow To Detect Chicanery at Frigitemp*, Wall St. J., Sept. 21, 1984, at 1, col. 6.

4. Even a cursory reading of Andersen's Brief In Opposition elicits an immediate question: why has it sought to bury the key arguments of the Petition in a secondary response in its Brief In Opposition? In light of *Superintendent*, the answer is not difficult to discern.

pledge were closely and inextricably linked. The fraud directly affected this securities transaction because in deciding whether the pledge of the Elsters stock (which was not publicly-traded and had no readily ascertainable market value) was sufficient security for Frigitemp's guarantee, the Banks had to know the real financial condition of Frigitemp.

Both the express holding of the Second Circuit majority and its chilling philosophy are in direct conflict with this Court's "touching" test of *Superintendent,* with the decisions of other circuits relying on it, and with the modern public responsibility of auditors as recently delineated by this Court in *United States* v. *Arthur Young & Co.,* 104 S. Ct. 1495, 1503 (1984).

Andersen fails to deal with the holding of *Superintendent,* the thirteen years of jurisprudence built upon its foundation, and the regressive fashion in which the majority below reverted to the lower court opinions in *Superintendent* which this Court there rejected (*see* Pet. 11-20). Andersen's sole attempt to distinguish the seminal precedent of *Superintendent* is that *Superintendent* "did not involve a *pledge* of stock" (Opp. 13) (emphasis added). That simply begs the question, because this Court held in *Rubin* that a pledge of stock was a sale of securities under the securities laws. Unless reversed, the Second Circuit majority's opinion will not be limited to pledge cases, but rather, in light of *Rubin,* will be applied broadly to every sort of securities case, erecting the very obstacles to enforcement policies that *Superintendent* deliberately eliminated.

The Banks also clearly established that the Second Circuit majority's opinion created a major conflict among the circuits (Pet. 20-22). Andersen relegates its ineffective attempt to distinguish these cases from the other circuits to a footnote (Opp. 14 n.14). There Andersen attempts to distinguish these cases, which expressly applied the "touch-

ing" test of *Superintendent,* by arguing that they "all involved a deceptive practice or scheme to defraud, where the sale of stock was an integral part of the fraud and was essential to its effectuation" (Opp. 14). The pledge here was an integral part of the fraud. More important, however, Andersen's reading of the cases to require such a showing cannot withstand analysis; the alleged fraud in those cases did not in any way relate to the value of the securities in question (as the Second Circuit majority here would require) but instead related to material collateral facts, as in this case.[5]

In *Kendrick,* for example, the defendant was a broker who drew unauthorized drafts on the margin accounts of two of his customers. These loans were secured by previously pledged stock and were made in reliance (as here) on fraudulent misrepresentations—there, that the loans were for the customers—not relating to the value of the securities themselves. Relying on *Superintendent*'s broad "touching" test, the Ninth Circuit held that the fraud was indeed sufficiently "in connection with," despite a touching far more tenuous than in the present case. In *Kendrick,* there was no misrepresentation as to the value of the pledged securities. The pledge preceded and was not induced by the fraud, and no new pledge was made as part of the transaction. The defendant's conviction in *Kendrick* was affirmed by the Ninth Circuit. The Second Circuit majority decision in this case is utterly irreconcilable with *Kendrick,* as well as with *Superintendent.* There certainly is a conflict among the circuits.

5. *See United States* v. *Kendrick,* 692 F.2d 1262 (9th Cir. 1982), *cert. denied,* 103 S. Ct. 1892 (1983); *McGrath* v. *Zenith Radio Corp.,* 651 F.2d 458 (7th Cir.), *cert. denied,* 454 U.S. 835 (1981); *Brown* v. *Ivie,* 661 F.2d 62 (5th Cir. 1981), *cert. denied,* 455 U.S. 990 (1982); *Mansbach* v. *Prescott, Ball & Turben,* 598 F.2d 1017 (6th Cir. 1979). *See also* (in addition to *Superintendent* itself) *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811 (2d Cir. 1975); *A.T. Brod & Co.* v. *Perlow,* 375 F.2d 393 (2d Cir. 1967).

In an effort to avoid this conflict (rather than address it), Andersen asserts that in cases involving pledged securities, "the courts have consistently held" that the in connection with requirement is not satisfied when there is no allegation of misrepresentations or omissions regarding the pledged securities (Opp. 12). *Kendrick* is directly contrary to such assertion, and no other court has held as Andersen suggests.

The only two cases cited by Andersen do not in any way support its position. *McClure* v. *First National Bank,* 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975), held only that the pledge of corporate stock for a renewal of a bank loan did not constitute a sale of securities—a decision which ceased to be the law even in that circuit after *Rubin.* More important, *McClure* contains no discussion at all concerning the interpretation of the "in connection with" language. Similarly, *Dopp* v. *Franklin National Bank,* 374 F. Supp. 904 (S.D.N.Y. 1974), contains no discussion or analysis of the "in connection with" language. In *Dopp,* the issue was whether a foreclosure against pledged stock in a private sale after the entry of a default judgment gave rise to any federal antifraud claim by the *pledgor.* The district court held that it did not because, as a matter of state commercial law under the Uniform Commercial Code, the pledgor had limited rights in foreclosure. No such state law implications exist here.[6]

The Banks also anticipated Andersen's attempt to avoid *Superintendent* by its reliance on a footnote in *Rubin,* 449 U.S. at 429 n.6 (Opp. 10). As noted by the Banks (Pet.

6. Andersen's claim (Opp. 15) that "the Banks had to know at the outset that federal jurisdiction was highly questionable" here is remarkable. The proof that the Banks reasonably believed that they had properly brought this case in federal court is that of the four judges to rule here, two (the District Court and the dissenting Second Circuit judge) agreed. Further, Andersen waited more than two years after the action had been filed before moving on jurisdictional grounds.

9-10 n.8), the question posed in the *Rubin* footnote as to Section 17(a) of the 1933 Act already had been answered in the affirmative under the 1934 Act by this Court in *Superintendent*. It defies logic to think that the *Rubin* Court meant to imply that the requisite relationship between an alleged fraud and a securities transaction differs depending on whether (a) the antifraud provisions of the 1933 Act, as opposed to the 1934 Act, are involved, or (b) whether a pledge, as opposed to another kind of sale of securities, the equivalent under *Rubin*, is involved. Andersen ignores this question entirely, as it must since neither distinction is theoretically sustainable nor finds any support whatsoever in this Court's body of precedent. However, by granting review in this case, this Court can remove all uncertainty concerning the application of *Superintendent* both to cases involving § 17(a) of the 1933 Act and to cases involving pledges of securities. This Court should dispel Andersen's claim that the *Rubin* footnote *sub silentio* overruled *Superintendent*.[7]

II. The Replacement Notes Are Securities

In the one integrated transaction of August 1977, the Banks (a) made a new investment decision by extending the maturity dates on $15.5 million of already overdue Notes —both secured (the "Note Endorsements") and unsecured

7. Andersen's attempt to rest on the hypothetical pledge of General Motors stock (Opp. 11-12) and its failure to deal with the realities of the record facts in this case (*compare* Pet. 17 n.12) is not surprising. That hypothetical pledge, by an unrelated borrower, of General Motors stock as collateral for a $100,000 commercial bank loan evidenced by a one month note, was correctly recognized by the dissenting judge in the Second Circuit as bearing no relationship whatsoever to the facts of the present case. This case involved the capital financing and restructuring of two-thirds of the total debt of Frigitemp, which guaranteed the loan to, and pledged as security therefor, all of the stock of its wholly-owned subsidiary—stock with neither a market nor any ascertainable market value. Thus the financial condition of Frigitemp was a vital consideration, and was closely intertwined with the value to the Banks of the pledged stock. This is not simply a "small" versus "large" company distinction as Andersen erroneously suggests (Opp. 12).

(the "Replacement Notes")—which they previously had accepted from Frigitemp in reliance upon prior certifications by Andersen (47a-48a); and (b) advanced $4 million of new money to Frigitemp's wholly-owned subsidiary, Elsters, which Frigitemp guaranteed (secured by the pledge, as discussed above). The Court of Appeals reversed the District Court's holding that the Replacement Notes were securities.

Andersen argues that the statutory interpretation underlying this Court's analysis of a "security" in *Securities Industry Association* v. *Board of Governors*, 104 S. Ct. 2979 (1984), is to be considered irrelevant merely because *Securities Industry* was decided under the Glass-Steagall Act. Indeed, Andersen goes so far as to assert that this Court has made it clear that "a decision under the Glass-Steagall Act has no relationship to the securities laws" (Opp. 9). Andersen errs. This Court expressly stated in *Securities Industry* that the securities acts and the Glass-Steagall Act were collectively designed to restore public confidence in financial markets and should be read together. 104 S. Ct. at 2987.

A "security" is defined for the antifraud provisions of (a) the 1933 Act as including "any note" (regardless of duration) and (b) the 1934 Act as including a "note" with a maturity exceeding nine months, in each case "unless the context otherwise requires."[8] Since, as the District Court found, the Replacement Notes had a maturity of eleven months (60a n.21), they fell squarely within both statutory definitions of a "security."[9] Given the magni-

8. Section 2(1) of the 1933 Act, 15 U.S.C.A. § 77b(1) (Supp. 1984); Section 3(a)(3) of the 1933 Act, 15 U.S.C.A. § 77c(a)(3) (1981); Section 3(a)(10) of the 1934 Act, 15 U.S.C.A. § 78c(a)(10) (Supp. 1984).

9. Despite Andersen's attempt to reshape the facts (Opp. 2-5) and its tortured discussion of other notes therein, this Petition on this issue deals only with the Replacement Notes.

tude and extremely risky character of the Replacement Notes, the context does not "otherwise require." Andersen's continued reliance (Opp. 6-7 and n.6) on the "commercial-investment" test to exclude the Replacement Notes from coverage only serves to commend this case for review. That test undeniably conflicts with the emphasis on the statutory language found in the Second Circuit's decisions in *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), and *Golden* v. *Garafalo*, 678 F.2d 1139 (2d Cir. 1982), and, most important, in this Court's decision in *Securities Industry* (*see* Pet. 25-27).

Andersen's argument that the Replacement Notes were not securities within the meaning of the 1933 and 1934 Acts thus depends entirely upon their position that the "context otherwise requires." They accomplish this by mischaracterizing the Replacement Notes as "ordinary" commercial loans. However, in reality, they bore no resemblance whatsoever to ordinary commercial notes. Rather, they represented the equivalent of equity capital, since the total financing provided by the August 1977 transaction represented some two-thirds of Frigitemp's total debt and 20% of its reported assets. And as the Second Circuit itself recognized, the financing was necessary because of Frigitemp's inability to raise funds in the traditional capital markets (8a and n.2) and because without it Frigitemp would go bankrupt (32a). Thus, the Banks were definitely at great risk with the Replacement Notes, rendering the instant case distinguishable on the key issue from *Marine Bank* v. *Weaver*, 455 U.S. 551, 558 (1982), where this Court held that federally insured certificates of deposit were not securities because they were risk-free. The Ninth Circuit recently agreed with this critical distinction. *See Wolf* v. *Banco Nacional de Mexico, S.A.*, No. 84-1693 (9th Cir. Aug. 10, 1984) (construing *Marine Bank* as creating an "insolvency protection" test).

III. Andersen's Argument That The Second Circuit Majority's Opinion Does Not Conflict With This Court's Rulings On Summary Judgment Is Based On A Demonstrably Incorrect Premise

Andersen contends (Opp. 15) that the opinion of the Second Circuit majority did not conflict with this Court's standards for summary judgment, claiming that the Petition did not state which facts found by the Second Circuit were in conflict with the record. But once again Andersen is wrong; Andersen ignores the fact that the Second Circuit made a critical factual finding that was unquestionably impermissible under, and in conflict with, the standards for summary judgment: that the pledge of stock was collateral and "merely an incident" to the key August 1977 integrated transaction (Pet. 23-24). That finding could not properly be made in the face of sworn record evidence to the contrary and the District Court's finding and the Second Circuit's own required assumption that no one part of that transaction could have stood alone since it was fully integrated. The Second Circuit majority's disassociation of the sale of securities from the rest of the August 1977 transaction, the entirety of which had been induced by Andersen's fraud, was an improper finding of fact and drawing of an inference by an appellate court against the party opposing summary judgment. Absent that finding, the Second Circuit majority could not have then ruled that Andersen's fraud was not "in connection with" the pledge.[10]

10. Andersen further argues that the Second Circuit majority granted a motion to dismiss, not a summary judgment motion. That is a misreading of the record. *See* 13a, 45a. Andersen moved to dismiss or for summary judgment for lack of subject matter jurisdiction, after much discovery (49a). The District Court denied both legs of the motion and only the latter was appealed. In any event, Andersen's argument is belied by its own Brief In Opposition, which contains a lengthy statement (or characterization) of facts which is completely inconsistent with the facts pleaded in the complaint. Thus it could not have been made on a motion to dismiss, where the facts pleaded must be taken as true and read as broadly as possible in favor of the plaintiff. *Conley* v. *Gibson*, 355 U.S. 41, 45-46 (1957).

Conclusion

For the reasons stated above and for the reasons stated in the Banks' Petition, a writ of certiorari should be issued to review the judgment of the United States Court of Appeals for the Second Circuit.

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